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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1941

No. 900

JOHN E. SHERIDAN AND LEO A. CROSSEN, TRUSTEES, MIFFLIN CHEMICAL CORPORATION, DEBTOR IN BANKRUPTCY REORGANIZATION PROCEEDINGS, SECTION 77B,
Petitioners,

vs.

WALTER J. ROTHENSIES, COLLECTOR OF INTERNAL REVENUE, FIRST COLLECTION DISTRICT OF PENNSYLVANIA.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT AND BRIEF IN SUPPORT THEREOF.

HARRY SHAPIRO,
Counsel for Petitioners.

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SUPREME COURT OF THE UNITED STATES

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No. 900

JOHN E. SHERIDAN AND LEO A. CROSSEN, TRUSTEES, MIFFLIN CHEMICAL CORPORATION, DEBTOR IN BANKRUPTCY REORGANIZATION PROCEEDINGS, SECTION 77B,

Petitioners,

vs.

WALTER J. ROTHENSIES, COLLECTOR OF INTERNAL REVENUE, FIRST COLLECTION DISTRICT OF PENNSYLVANIA,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

To the Honorable the Justices of the Supreme Court of the United States:

The petition of John E. Sheridan and Leo A. Crossen, Trustees for Mifflin Chemical Corporation, debtor, petitioners, by their attorneys, Harry Shapiro, Esq., and Wexler and Weisman, Esqs., respectfully prays that a writ of certiorari issue to review the decree of the Circuit Court of Appeals for the Third Circuit entered on October 29, 1941, affirming a certain order entered by the District Court of the United States for the Eastern District of Pennsylvania.

Statement of Case.

On January 14, 1938, Mifflin Chemical Corporation, the debtor above named, filed a petition for reorganization under Section 77B of the then Bankruptcy Act. Judge Kirkpatrick allowed the petition, continued the debtor in possession, and referred the matter generally to David Werner Amram, Esq., as Special Master.

Walter J. Rothensies, Collector of Internal Revenue for the first collection district of Pennsylvania, thereafter filed a jeopardy tax claim against the debtor in the amount of $254,746.80.

The tax was assessed on the theory that the debtor sold rubbing alcohol to certain of its customers in excess of their reasonable requirements in violation of Article 146 of Regulations No. 3 promulgated by the Commissioner of Internal Revenue, as amended by Treasury Decision 4541, approved April 17, 1935 (Volume 33, Treasury Decisions, Internal Revenue, 90, 93) which provides, in part, as follows:

> "The sales of this product must be confined to persons legitimately engaged in a bona fide drug trade * * * Failure to comply with these requirements and to confine sales to such persons, or the making of sales to such persons in quantities in excess of their reasonable requirements, will constitute bad faith on the part of the permittee and grounds for the revocation of his permit."

The Collector further contended that since the sale of rubbing alcohol compound in excess of reasonable requirements violated the quoted regulation, the denatured alcohol so sold became subject to the same tax as undenatured alcohol under the provisions of Section 4 of the Liquor Law Repeal and Enforcement Act of 1935 (Act of August 27, 1935, c. 740, §4, 49 Stat. 873, 27 U. S. C. 153), since repealed and incorporated as Section 3111 of the Internal

Revenue Code of 1939 (Act of February 10, 1939, c. 2, §3111, 53 Stat. 1, 26 U. S. C. 3111), which provides as follows:

> "Any person who shall produce, withdraw, sell, transport, or use denatured alcohol, denatured rum, or articles, in violation of laws or regulations now or hereafter in force pertaining thereto, and all such denatured alcohol, denatured rum or articles shall be subject to all provisions of law pertaining to alcohol that is not denatured, including those requiring the payment of tax thereon; and the person so producing, withdrawing, selling, transporting or using the denatured alcohol, denatured rum, or articles shall be required to pay such tax."

The debtor contested the tax claim and the Special Master held a number of hearings to determine the tax claim's validity.

At the hearings the Collector offered testimony in support of the tax claim. The testimony showed that some of the rubbing alcohol compound sold by the debtor to legitimate customers was later resold by the said customers to bootleggers for illegal purposes; that two of the debtor's salesmen knew that some of the alcohol compound so sold by the debtor to its customers was intended to be diverted by the said bootleggers and held conversations with the bootleggers concerning the diversion; that the said salesmen deliberately concealed their knowledge and dealings with the said bootleggers from the debtor because they feared that if the debtor knew of such knowledge and dealings it would discharge the salesmen and cease selling rubbing alcohol compound to customers who resold to the bootleggers.

The record admittedly lacks competent evidence as to the amount of rubbing alcohol sold by the debtor to its customers and resold to bootleggers because the Master,

over the objection of the Collector, refused to hear the testimony of debtor's customers with respect to the disposition made by such customers of the rubbing alcohol purchased from the debtor.

At the conclusion of the claimant's testimony before the Special Master, the debtor moved to dismiss the claim, reserving to itself the right to offer testimony. The claim was thereafter disallowed by the Special Master and consequently the debtor offered no testimony.

The Special Master then prepared and signed a report recommending that the proof of debt of the Collector of Internal Revenue be disallowed. Thereafter the Special Master prepared a supplemental report incorporating certain findings of fact requested by the debtor. Referee Amram died before he signed said supplemental report, and the matter was then referred by the District Court to David Bachman, Esq., as substituted Special Master who approved and filed the said report and supplemental report on July 11, 1939.

The said report and supplemental report of the Special Master summarize the said testimony in narrative form with reference to the page numbers of the testimony (R. 322, 363).

The Special Master found that the debtor and its officers had no knowledge or means of knowledge of the said diversion (R. 358); that all of the customers to whom the debtor sold the rubbing alcohol compound were within the category of persons entitled to purchase the same within Article 146 of Regulations No. 3 (R. 358); that the debtor made no sales of rubbing alcohol compound in bad faith or in excess of the reasonable requirements of its customers (R. 358, 359); that the connection between the debtor's salesmen and the bootleggers was concealed from the debtor and the debtor had no knowledge or means of knowledge thereof (R. 359); that the dealings between the salesmen and the

bootleggers did not occur in pursuance of their duties as salesmen but were for their own benefit to the damage of the debtor, and in violation of orders received by them from the debtor that rubbing alcohol compound was to be sold only for legitimate purposes (R. 359).

Exceptions were thereupon filed by the claimant and a hearing was held thereon before District Judge Bard who, on July 24, 1940, by written opinion filed on said date, set aside the said reports and directed that the said tax claim be allowed in the amount of $187,488.00, together with interest at one-half (½) per cent per month from January 15, 1938. On August 2, 1940, the debtor filed, and on January 14, 1941, Judge Bard dismissed, a motion for rehearing.

On February 10, 1941, Judge Bard entered an order and decree setting aside the Master's reports and allowing the tax claim in the amount of $187,488.00, together with interest at one-half (½) per cent per month from January 15, 1938.

On March 11, 1941, the debtor filed a notice of appeal from the said order and decree.

On April 4, 1941, Judge Bard, upon motion of the Collector and other creditors of the debtor to appoint trustees to supplant Mifflin Chemical Corporation, debtor in possession, appointed John E. Sheridan, Esq., and Leo A. Crossen, Trustees for the debtor corporation. On April 9, 1941, Judge Bard entered an order extending the time for the filing of the record sur appeal for a further period of forty days. Thereafter the Trustees appealed from said order and decree of February 10, 1941, to the Circuit Court of Appeals for the Third Circuit.

At the argument before the Circuit Court, the Trustees urged that Judge Bard erred for the following reasons:

(a) Judge Bard erred in finding that sales in excess of reasonable requirements are prohibited by Article 146 of

Regulations No. 3, and therefore taxable under Section 4 of the said Act, since Article 146 simply deals with the granting of permits for denatured alcohol and the conduct of permittees thereunder and by its terms does not prohibit such sales but simply states that such sales are evidence of bad faith and grounds for the revocation of the permit.

(b) Since the case arose on a demurrer to claimant's testimony sustained by the Master, it was error for Judge Bard to allow the claim without remanding the cause to the Master with instructions to hear the testimony of the Trustees in opposition to the claim, particularly since the Trustees, who represent large and substantial creditor interests, had been appointed after the hearings before the Master had been concluded and his report filed.

(c) The District Court erred in imputing the alleged wrongful acts and knowledge of Mifflin's salesmen to Mifflin; since, with respect to such wrongful acts and knowledge, the salesmen were engaged, beyond the scope of their authority, and adversely to the interest of Mifflin, in an independent, fraudulent enterprise, whose success would be defeated by disclosure to Mifflin of the acts or knowledge sought to be imputed.

(d) Since the Master, Judge Bard and the Collector *all* stated that the testimony lacked competent evidence of the *amount* of sales in excess of reasonable requirements, it was error for the District Court to make a finding of the amount of such sales of alcohol and the tax due thereon.

(e) Since the Master's findings of fact are adequately and sufficiently supported by the testimony, Judge Bard erred in setting aside said findings.

(f) The Act and Regulation, if construed so as to impose a tax on sales of rubbing alcohol compound by a permittee in excess of its customers' reasonable requirements, are unconstitutional.

The Circuit Court, on October 29, 1941, affirmed the order of the District Court. It was held that no error was committed in allowing the claim for taxes without remanding the case to the Master to give the Trustees an opportunity to offer testimony for two reasons: *first*, a master functions in an advisory capacity only; he does not sit as a court; and it is his function merely to hear and report his findings of fact and conclusions of law; *secondly*, the Trustees were given an opportunity to be heard, but did not choose to offer testimony, and therefore do not have the right now to obtain another opportunity because of an adverse decision.

The Circuit Court held that "we cannot say that there was no substantial basis" for the factual findings of Judge Bard and, therefore, under FRCP No. 52(a), it could not disturb such factual findings.

The Circuit Court, without discussion, passed over the Trustees' argument that no tax at all can be exacted under the said Regulation and Act with the statement that "Mifflin's contention that alcohol improperly withdrawn is not subject to tax but only subjects the producer or seller to revocation of permit is without foundation."

Finally the Circuit Court concluded that even though Mifflin had no actual knowledge of the illicit distribution of its rubbing alcohol compound, and even though it is conceded that its employees were violating instructions and concealing their activities from Mifflin, Mifflin was nevertheless responsible for the knowledge of its employees under the general rule of *respondeat superior*.

Jurisdiction.

1. The jurisdiction of this Court is invoked under the provisions of Section 240 (a) of the Judicial Code, as amended (March 3, 1891, c. 517, Sec. 6, 26 Stat. 828, as amended; 28 U. S. C. Section 347 (a)).

2. The Circuit Court has decided important questions of federal law which have not been, but should be, settled by this Court; and its decision in other respects is in direct conflict with applicable decisions of this Court and other circuit courts.

3. The date of the opinion and decree of the Circuit Court to be reviewed is October 29, 1941.

Statement of Questions Presented.

1. Are sales of alcohol by a permittee in excess of its customers' reasonable requirements taxable under Article 146 of Treasury Department Regulations No. 3 relative to industrial alcohol, and Section 4 of the Liquor Law Repeal and Enforcement Act of 1935?

2. Are the said Act and Regulation, if construed so as to impose a tax on sales in excess of reasonable requirements, unconstitutional in that (a) the act unconstitutionally delegates legislative and taxing power to the Commissioner; (b) the regulation is not authorized by, and is not within the framework of, any taxing statute, and is therefore an invalid and unauthorized basis for the exaction of any tax?

3. Where, in 77B proceedings, a debtor is continued in possession, and a tax claim based on sale of tax exempt alcohol in excess of customers' reasonable requirements is disputed by the debtor and referred to a master who, on the claimant's testimony and debtor's demurrer thereto, disallows the claim, may a reviewing court reverse the master and allow the claim without remanding the cause to the master with instructions to hear testimony in opposition thereto, particularly where trustees for the debtor representing large and substantial creditor interests, were appointed after the master's hearings had been concluded and his report filed?

4. May a reviewing court set aside findings of fact of a special master appointed in 77B proceedings where the master, but not the court, has seen and heard the witnesses and the master's findings of fact are sufficiently and adequately supported by the testimony?

5. Did the Circuit Court err in imputing the alleged wrongful acts and knowledge of Mifflin's salesmen to Mifflin where, with respect to such wrongful acts and knowledge, the salesmen were engaged, beyond the scope of their authority, and adversely to the interest of Mifflin, in an independent, fraudulent enterprise, whose success would be defeated by disclosure to Mifflin of the acts or knowledge sought to be imputed?

6. Did the District Court err in making its own specific findings of the amount of sales of alcohol in excess of Mifflin's customers' reasonable requirements, in view of the fact that the Master, Judge Bard, and the Collector all stated that the testimony lacked competent evidence of the amount of sales in excess of reasonable requirements?

Reasons for Allowance of Writ.

The grounds relied upon by petitioners for the allowance of the writ are:

1. The Circuit Court has decided an important question of federal law which has not been, but should be, settled by this Court, to wit, whether sales in excess of reasonable requirements of customers are taxable under Section 4 of the Liquor Law Repeal and Enforcement Act of 1935 (Act of August 27, 1935, c. 740, § 4, 49 Stat. 873, 27 U. S. C. 153), since repealed and incorporated as Section 3111 of the Internal Revenue Code of 1939 (Act of February 10, 1939, c. 2, § 3111, 53 Stat. 1, 26 U. S. C. 3111), and Article 146 of

Regulations No. 3, relative to industrial alcohol, as amended by Treasury Decision 4541, approved April 17, 1935 (Volume 33, Treasury Decisions, Internal Revenue, 90, 93).

2. The Circuit Court has decided an important question of federal law which has not been, but should be, settled by this Court, to wit, the constitutionality of the said Act and Regulation when construed so as to impose a tax on sales of rubbing alcohol compound by a permittee in excess of its customers' reasonable requirements.

3. The decision of the Circuit Court is in conflict with decisions of other circuit courts in that it failed to hold that, since the case arose on a demurrer to the claimant's testimony sustained by the Master, it was error for the District Court to allow the claim without remanding the cause to the Master with instructions to hear the testimony of the Trustees in opposition to the claim, particularly since the Trustees were appointed only after the Master's hearings had been concluded and his report filed with the District Court.

The conflicting cases of other circuit courts are as follows:

In re John H. Livingston Co., 144 F. 971 (C. C. A. 2d, 1905);
In re Crandall, 205 F. 689, 692 (C. C. A. 9th, 1913).

4. The decision of the Circuit Court is in conflict with decisions of this Court and other circuit courts in that it failed to hold that the District Court erred in setting aside the findings of fact of a master appointed in 77B proceedings where the master, but not the court, has seen and heard the witnesses, and the master's findings are sufficiently and adequately supported by the testimony.

The conflicting decisions of this Court and other circuit courts are as follows:

Kimberly v. *Arms*, 129 U. S. 512, 9 S. Ct. 355 (1888);
Matter of Rubins, 74 F. (2d) 432 (C. C. A. 7th, 1935), cert. den. 295 U. S. 758, 55 S. Ct. 915 (1935);
Clements v. *Coplin*, 72 F. (2d) 796 (C. C. A. 9th, 1934).

5. The decision of the Circuit Court is in conflict with decisions of this Court and other circuit courts in that it imputed the alleged wrongful acts and knowledge of Mifflin's salesmen to Mifflin; since, with respect to such wrongful acts and knowledge, the salesmen were engaged beyond the scope of their authority, and adversely to the interest of Mifflin in an independent fraudulent enterprise whose success would be defeated by disclosure to Mifflin of the acts or knowledge sought to be imputed.

The conflicting decisions of this Court and other circuit courts are as follows:

Schutz v. *Jordan*, 141 U. S. 213, 11 S. Ct. 906 (1891);
American Surety v. *Pauley*, 170 U. S. 133, 18 S. Ct. 552 (1898);
Bank of Overton v. *Thompson*, 118 F. 798 (C. C. A. 8th, 1902);
Dixie Guano Co. v. *Wessel*, 296 F. 433 (C. C. A. 4th, 1924);
Great American Indemnity Co. v. *First National Bank*, 100 F. (2d) 763 (C. C. A. 10th, 1938).

6. The decision of the Circuit Court is in conflict with decisions of other circuit courts in that it permitted the District Court to make findings of specific quantities in the absence of competent evidence with respect to quantities.

The conflicting decisions of other circuit courts are as follows:

Forbush v. *Bartley*, 78 F. (2d) 805 (C. C. A. 10th, 1935);
Matter of Sheinman, 14 F. (2d) 323 (D. C. E. D. Pa., 1926);
Matter of Robin, 32 Am. B. R. (N. S.) 462 (D. C. Tex., 1937).

Prayer.

WHEREFORE, your petitioners respectfully pray that a writ of certiorari be issued out of and under the seal of this Honorable Court, directed to the Circuit Court of Appeals for the Third Circuit, commanding that court to certify to and send to this Court for its review and determination, on a day certain to be therein named, a full and complete transcript of the record and all proceedings in the case numbered and entitled on its docket October Term, 1940, No. 7692, In re Mifflin Chemical Corporation, Debtor (Reorganization Proceedings—Section 77B), John E. Sheridan and Leo A. Crossen, Trustees, Mifflin Chemical Corporation, Debtor, Appellants, *v.* Walter J. Rothensies, Collector of Internal Revenue, Appellee; and that the decree of the Circuit Court for the Third Circuit may be reversed by this Honorable Court, and that your petitioners may have such other and further relief in the premises as to this Honorable Court may seem meet and just.

And your petitioners will ever pray.

WEXLER & WEISMAN,
HARRY SHAPIRO,
Counsel for Petitioners.

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1941

No. 900

IN RE: MIFFLIN CHEMICAL CORPORATION,
Debtor,

(Reorganization Proceedings—Section 77B.)

JOHN E. SHERIDAN AND LEO A. CROSSEN, TRUSTEES, MIFFLIN CHEMICAL CORPORATION, DEBTOR IN BANKRUPTCY REORGANIZATION PROCEEDINGS, SECTION 77B,
Petitioners,

vs.

WALTER J. ROTHENSIES, COLLECTOR OF INTERNAL REVENUE, FIRST COLLECTION DISTRICT OF PENNSYLVANIA,
Respondent.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

Opinions Below.

The opinion of the District Court is reported in *In re Mifflin Chemical Corporation,* 34 F. Supp. 164 (D. C. E. D. Pa., 1940).

The opinion of the Circuit Court is reported in *In re Mifflin Chemical Corporation, Sheridan, et al.,* v. *Rothensies,* 123 F. (2d) 311 (C. C. A. 3rd, 1941).

Jurisdiction.

The date of the opinion of the Circuit Court of Appeals for the Third Circuit to be reviewed is October 29, 1941.

The jurisdiction of this Court is invoked under the provisions of Section 240 (a) of the Judicial Code, as amended (March 3, 1891, c. 517, § 6, 26 Stat. 828, as amended; 28 U. S. C. 347 (a)).

Statement of Questions Presented.

The foregoing petition for writ of certiorari contains a statement of questions presented which, for the sake of brevity, is not here repeated.

Statement of Case.

The foregoing petition for writ of certiorari contains a concise statement of case which, for the sake of brevity, is not here repeated.

Specification of Errors.

The foregoing petition for writ of certiorari contains a statement of assigned errors, under the heading of "Reasons for Allowance of Writ", which, for the sake of brevity, is not here repeated. Petitioners intend to urge each and all of the said errors.

ARGUMENT.

I.

Sales in excess of reasonable requirements are not taxable under Title 27, U. S. Code, § 153 (now Title 26, U. S. Code, § 3111) and Article 146 of Regulations No. 3.

Judge Bard found that Mifflin made sales in excess of reasonable requirements of its customers; that such sales were in violation of Article 146 of Regulations No. 3; and

that consequently a tax became due under and by virtue of the terms of Section 4 of the Liquor Law Repeal and Enforcement Act of 1935.

Section 4 of the Liquor Law Repeal and Enforcement Act of 1935 (Act of Aug. 27, 1935, c. 740, §4, 49 Stat. 873, 27 U. S. C. 153), since repealed and incorporated as Section 3111 of the Internal Revenue Code of 1939 (Act of Feb. 10, 1939, c. 2, §3111, 53 Stat. 1, 26 U. S. C. 3111) provides as follows:

> "Any person who shall produce, withdraw, sell, transport, or use denatured alcohol, denatured rum, or articles, in violation of laws or regulations now or hereafter in force pertaining thereto, and all such denatured alcohol, denatured rum, or articles shall be subject to all provisions of law pertaining to alcohol that is not denatured, including those requiring the payment of tax thereon; and the person so producing, withdrawing, selling, transporting or using the denatured alcohol, denatured rum, or articles shall be required to pay such tax."

Article 146 of Regulations No. 3, relative to industrial alcohol, as amended by Treasury Decision 4541, approved April 17, 1935 (Volume 33, Treasury Decisions, Internal Revenue, 90, 93) provides, *inter alia*, as follows:

> "The sales of this product must be confined to persons legitimately engaged in a bona fide drug trade, or to hospitals, sanitariums, turkish baths or other establishments or stores where such compounds have customarily been sold, or used for massage or other external purposes. Failure to comply with these requirements and to confine sales to such persons, or the making of sales to such persons in quantities in excess of their reasonable requirements will constitute bad faith on the part of the permittee and grounds for the revocation of his permit."

Sales in "excess of reasonable requirements" are therefore not prohibited by any law and not even referred to in

any regulation except Article 146 of Regulations 3. The Collector's case therefore, is founded on the theory that sales in excess of reasonable requirements are forbidden by Article 146 and are therefore taxable under Section 4 of the Liquor Law Repeal and Enforcement Act.

It therefore follows that unless the Collector sustains his proposition that such sales are forbidden by Article 146, the sales are not taxable.

It is submitted that both the Collector and Judge Bard overlooked the simple but obvious fact that *Article 146 does not forbid sales in excess of reasonable requirements,* but merely states that such sales would constitute bad faith on the part of the vendor and cause for the revocation of his permit. In other words, *sales in excess of reasonable requirements do not violate any part of the regulation* and therefore such sales are not taxable under the taxing statute.

The Circuit Court, without discussion, disposed of the foregoing argument with the statement that "Mifflin's contention that alcohol improperly withdrawn is not subject to tax but only subjects a producer or seller to revocation of permit is without foundation" (R. 430).

It seems obvious that the regulation deals only with the grant of permits and the conduct of permittees thereunder. It was not intended to, nor does it by its terms, prohibit sales in excess of reasonable requirements; it simply states that sales in excess of reasonable requirements shall be evidence of bad faith and that the penalty for such bad faith shall be revocation of the permit.

The obvious reason is that there is not and cannot be any definite test for measuring "reasonable requirements." Who can foresee with any degree of certainty the reasonable requirements of Sears, Roebuck and Co. or any of the five and ten cent stores, or chain drug stores? Their requirements may and will vary daily; certainly they will vary

with the policy of the business; certainly they will vary insofar as debtor or any other manufacturer is concerned, depending on the percentage of total needs purchased from such manufacturer. If Sears, Roebuck and Co., or Woolworth, or Grant, or McCrory, or Kresge, or Walgreens, or Nevins, or Sun Ray determine to use debtor's rubbing alcohol compound as a cut rate or loss leader, any of them alone might very well legitimately buy and legitimately sell all the debtor's output.

"Reasonable requirements," however, to the extent that they can be fixed and determined, mean and define not the use which customers make of the rubbing alcohol compound after its purchase, but rather their requirements or needs *at* or *prior* to the time of purchase. Consequently the ultimate use or disposition of the rubbing alcohol compound, whether licit or illicit, bears no relation to, and does not prove, the amount or extent of the customer's reasonable requirements.

Article 146 clearly reveals the intent of the framers. Illegitimate sales to persons not engaged in business legitimately using denatured alcohol were forbidden and thus made taxable because the existence and extent of such sales are capable of exact proof or denial. As averred hereinbefore, however, there is not and cannot be any definite test for measuring "reasonable requirements", and therefore neither the existence nor extent of sales alleged to be in excess of reasonable requirements can be measured, proved or denied with exact certainty. It was therefore intended that if a permittee made sales in excess of reasonable requirements, to the extent that "reasonable requirements" can be fixed and determined, such sales would be deemed to have been made in bad faith and the permittee's permit revoked. No tax or further penalty would be imposed, however, since it would be impossible either for

the government or the permittee to prove or disprove with certainty either the sale or its extent.

So construed, the distinction made by Article 146 between illegitimate sales and sales in excess of reasonable requirements is logical and understandable; likewise it is clear that it was not intended to penalize unprovable sales in excess of non-measurable reasonable requirements by taxing the indeterminate amount of the denatured alcohol involved therein.

Since the statute imposes a tax, and particularly a penal tax, both the statute and the regulation whose violation is invoked to bring the statute into operation must be strictly construed. The canons of construction governing the interpretation of such statutes are stated in 59 C. J. paragraphs 569, 660 and 670 as follows:

> "The intention of the legislature is to be obtained primarily from the language used in the statute * * * Where the language of a statute is plain and unambiguous, there is no occasion for construction even though other meanings could be found, and the court cannot indulge in speculation as to the probable or possible qualifications which might have been in the mind of the legislature, but the statute must be given effect according to its plain and obvious meaning and cannot be extended beyond it.
>
> "* * * it is a fundamental rule in the construction of statutes that penal statutes must be construed strictly (*Prussian vs. U. S.*, 282 U. S. 675, 51 S. Ct. 223 (1931); *U. S. v. Fruit Growers' Express Co.*, 279 U. S. 363, 49 S. Ct. 374 (1929)) * * * under the rule of strict construction, such statutes will not be enlarged by implication or intendment beyond the fair meaning of the language used, and will not be held to include other offenses and persons than those which are clearly described and provided for although the court may think the legislature should have made them more comprehensive (*U. C. v. Weitzel*, 246 U. S. 533, 38 S. Ct. 381 (1918); *U. S. vs. N. Y. Central R. R. Co.*, 212 U. S.

509, 29 S. Ct. 313 (1909)) * * * *In order to enforce a penalty against a person, he must be brought clearly within both the spirit and the letter of the statute; and if there is a fair doubt as to whether the act charged is embraced in the prohibition, that doubt is to be resolved in favor of defendant* (*Chase vs. Curtis*, 113 U. S. 452, 5 S. Ct. 554 (1885); *U. S. vs. J. H. Winchester & Co.*, 40 F. (2d) 472 (C. C. A. 2d, (1930)).

"* * * As a general rule revenue laws, such as laws imposing taxes and licenses, operate to impose burdens upon the public, or to restrict them in the enjoyment of their property and the pursuit of their occupations, and, *when they are ambiguous or doubtful will be construed strictly in favor of the taxpayer and against the taxing power* (*Bowers vs. New York & Albany Lighterage Co.*, 273 U. S. 346, 47 S. Ct. 389 (1927); *Hecht vs. Malley*, 265 U. S. 144, 44 S. Ct. 144 (1923)) * * * the provisions of such statutes are not to be extended by construction or implication beyond the clear import of the language used (*Crooks vs. Harrelson*, 282 U. S. 55, 51 S. Ct. 49 (1930); *Hecht vs. Malley*, supra) * * * In order to sustain the tax, it must come clearly within the letter of the statute (*Alvea-Nichols Co. vs. U. S.*, 12 F. (2d) 998 (D. C. Ill., 1926))."

See also *U. S.* vs. *Merrian*, 263 U. S. 179, 44 S. Ct. 69 (1923), which holds that all doubts as to the construction of revenue statutes must be resolved in favor of the taxpayer.

So construed and interpreted the regulation does not forbid or prohibit sales in excess of reasonable requirements and therefore such sales are not taxable. It necessarily follows that even were we to admit that debtor sold rubbing alcohol compound to its customers in excess of their reasonable requirements, such sales are nevertheless nontaxable and therefore the claim for taxes must be denied.

II.

The said Act and Regulation, if construed so as to impose a tax on sales in excess of reasonable requirements, are unconstitutional.

It has been argued above that sales of rubbing alcohol compound by a permittee in excess of its customers' reasonable requirements are not taxable under the cited act and regulation. If, however, the said act and regulation are construed so as to impose a tax on such sales, it is submitted that they are unconstitutional and invalid in that:

First, the act is an unconstitutional delegation of legislative power since it delegates to the Commissioner the power to create the tax by enacting a regulation, the violation of which automatically makes the tax due and payable;

Secondly, the regulation is not authorized by any policy, standard, or rule of any taxing statute; it is required and authorized only by the act dealing with the licensing of denatured alcohol and the conduct of permittees thereunder; and is not within the framework of any taxing statute. Hence, the regulation is an invalid and unauthorized basis for the exaction of any tax.

The precise constitutional objections raised here are unadjudicated. The reported cases sustaining the power of the Commissioner of Internal Revenue to enact regulations and determine the taxable status of persons handling denatured alcohol, do not deal with, and therefore do not govern, the cited section of the act and article of the regulation: see *Rothensies* v. *Lichtenstein,* 91 F. (2d) 544 (C. C. A. 3d, 1937); *U. S.* v. *Rosenzweig,* 25 F. Supp. 811 (D. C. M. D. Pa., 1939); *Jacoby* v. *Hoey,* 86 F. (2d) 108 (C. C. A. 2d, 1936); *Driscoll* v. *Jones,* 19 F. Supp. 792 (D. C. Okl., 1937).

III.

The District Court erred in allowing the claim without remanding the case to the Master with directions to give the Trustees an opportunity to offer testimony in opposition thereto.

At the conclusion of the claimant's testimony before the Special Master, the debtor moved to dismiss the claim, reserving to itself the right to offer testimony. Subsequently, on March 27, 1939, the Special Master filed a memorandum opinion which in part reads as follows (R. 322):

> "On page 290 of the notes of testimony Mr. Shapiro, attorney for the debtor, has reserved the right to offer testimony dependent upon the motion to strike off. I may say that I have fully considered the record as it stands, and have reached the conclusion that the proof of claim of the Collector of Internal Revenue must be disallowed."

Since the claim was disallowed by the Special Master, testimony in opposition to the claim was unnecessary. Even though the District Court found that the claimant had made out a *prima facie* case, in view of the debtor's reservation of the right to offer testimony, Trustees representing large and substantial creditor interests, who were appointed after the Master concluded his hearings and filed his report with the District Court, should not be prejudiced by a peremptory allowance of the claim, but should at least be given an opportunity to offer a defense thereto.

It is submitted that it was error for the District Court, at this stage of the proceedings, to allow any claim whatsoever on behalf of the Collector and that well settled procedure requires that the cause be remanded to the Special Master so that the Trustees will have an oppor-

tunity to present whatever proof they may have tending to controvert the claim.

A similar situation was presented in *In re John H. Livingston Co.*, 144 F. 971 (C. C. A. 2d, 1905). In that case the claimant presented evidence in support of his claim before the Referee. At the close of the claimant's case the Trustee moved that the claim be disallowed. The Referee granted the motion and disallowed the claim. On appeal to the District Court the Referee's order was reversed and the claim was allowed as filed. On appeal, the Circuit Court held:

> "We think this was error because, by such disposition of the cause, the claim was allowed without any opportunity to the Trustee to put in what proof he might be able to produce tending to controvert the case made by the claimant. The order is refused and cause remanded with directions to allow the Trustee to put in his proofs and to pass upon the question upon the testimony presented by both sides."

In re Arthur E. Pratt Co., 252 F. 917 (D. C. N. D. N. Y., 1918). The Referee disallowed a claim. The District Court considered at length the testimony and found that some of the objections of the Trustee to the testimony should have been overruled, and held that "as the case stands the weight of the evidence is with the claimant; but with all the pertinent facts fully developed it might not be." The Court therefore sent the matter back to the Referee for rehearing.

In re Tenebaum, 56 F. (2d) 217, 218 (D. C. S. D. N. Y., 1931). The Referee disallowed a claim by a landlord by not giving the landlord the benefit of a presumption that payment of rent and the possession of premises by the bankrupt validated an oral assignment of the lease to the bankrupt by a prior tenant of the premises. The Court said:

> "I have no way of knowing what the Referee's decision would have been if he had given to the claim-

ant the advantage of the presumption to which he was entitled and had weighed the bankrupt's evidence in one scale against that presumption and the evidence offered by the claimant in support of it on the other scale. The proper course in such a case is to reverse the order and to remand the matter to the Referee for rehearing."

In re Crandall, 205 F. 689, 692 (C. C. A. 9th, 1913). The Referee disallowed the claim and the District Court set aside the Referee's action and allowed the claim. On appeal by the Trustee the Circuit Court said:

> "The Referee proceeded under the belief that the sworn proof * * * was no evidence at all * * * By his action * * * he ignored material legal evidence * * * The District Court * * * properly held that the Referee was in error * * * The order of the lower court allowed the claim * * * but as the proof of claim was not conclusive, such a disposition of the matter seems irregular. The Referee should proceed to a new hearing, whereat the sworn proof of the claimant must be considered, and the Trustee should be given opportunity to meet the case made by the claimant's proof."

In the instant case, the Master ruled the claimant failed to establish a *prima facie* case. Until reversed by a reviewing court, that ruling determined that the debtor was not obliged to rebut the claimant's evidence and correlatively the debtor had no legal right to do so. The Master's ruling bound the debtor just as much as it did the claimant; and for the time being, not only decided that the Collector had no valid claim, but barred the debtor from presenting a defense.

When the District Court reversed the Master, however, it not only held, in effect, that the claimant had proved his case and therefore the debtor was obliged to rebut it, but also necessarily held, in effect, that because of the Master's

ruling in the debtor's favor, it had lost its right to present a defense. This consequence is contrary to our Anglo-Saxon system of law which has always held that no litigant shall be deprived of his right to a complete trial because a court erroneously found in his favor before he presented his defense. No litigant should be prejudiced because he observed the decision of a court in his favor; and no litigant should be put to the choice of deciding whether a judicial decision in his favor should or should not be observed on the threat of the penalty that if the court erroneously decided for him, he will be prejudiced.

Such, however, was the effect of the District Court's decree. The cause should have been referred back to the Master just as if a nonsuit had been erroneously entered in a jury trial.

That historic rule is based on sound reasoning. Its justice is emphasized when we examine the testimony on which the District Court entered judgment. Nearly all of the relevant testimony came from convicted racketeers who had already received, or who had reason to believe they would receive, leniency from the government in return for their testimony on behalf of the Collector.

Certainly the debtor was entitled to an opportunity to offer evidence in opposition to the testimony of the convicted racketeers on which the Collector bases his claim; *a fortiori,* Trustees representing substantial creditor interests who were appointed only after the Master's hearings were concluded, should not be bound by that testimony until they have had an opportunity to demonstrate its falsity.

It is submitted, therefore, that Judge Bard erred in allowing the claim at this stage of the proceedings, and that he should have remanded the cause to the Special Master with instructions to allow the Trustees to submit testimony in opposition to the claim.

Moreover, it is probable that the decision of the Circuit Court sustaining Judge Bard was based on the misapprehension that the Trustees had been appointed *prior* to the hearings before the Special Master (opinion of Circuit Court, R. 427), when in fact, as will be seen by reference to the docket entries and the record, the hearings before the Special Master commenced on May 18, 1938 (R. 7), and were concluded on September 8, 1938 (R. 272); the Master's report was filed on July 11, 1939 (R. 1); but the Trustees were not appointed until April 4, 1941 (R. 423), nearly two years after the Special Master's report had been filed with the Court.

IV.

The District Court erred in setting aside the findings of fact of the Special Master.

It is well settled, by decisional and statutory law alike, that the findings of fact of the trier of the facts, who has seen and heard the witnesses, will not be set aside unless such findings are wholly unsupported by the evidence: *Kimberly* v. *Arms*, 129 U. S. 512, 9 S. Ct. 355 (1888); *In re Pullmatch, Inc.*, 27 F. Supp. 884 (D. C. S. D. Ohio, W. D. 1939); *Wald* v. *Longacre*, 34 F. (2d) 25 (C. C. A. 3d, 1931); *Clements* v. *Coplin*, 72 F. (2d) 769 (C. C. A. 9th, 1934); *In re Rubins*, 74 F. (2d) 432 (C. C. A. 7th, 1935), cert. den. 295 U. S. 758, 55 S. Ct. 915 (1935).

That rule, too, governs the weight to be given the findings of the Master in a bankruptcy case instituted prior to the effective date of the Chandler Act and the Federal Rules of Civil Procedure.

In the Matter of Philpott (S. D., W. Va., Bankruptcy No. 3395, December 30, 1940, unreported), it was said:

> "Question has been raised as to what weight the court should give to the master's findings in a bankruptcy case instituted prior to the effective date of the

> Chandler Act and of the Federal Rules of Civil Procedure. Under the terms of present General Order 37, the Federal Rules of Civil Procedure relating to special masters is now applicable to all matters pertaining to the appointment and powers of and the proceedings before such masters where not inconsistent with the act or the general orders. Rule 53 (e) should be read with General Order 47, and if this is done, no inconsistency appears. General Order 47 provides: 'Unless otherwise directed in the order of reference, the report of a referee or of a special master shall set forth his findings of fact and conclusions of law, and the judge shall accept his findings of fact unless clearly erroneous. The judge, after hearing, may adopt the report or may modify it or may reject it in whole or in part or may receive further evidence or may recommit it with instructions.' Rule 53 (e) (2) provides that: 'In an action to be tried without a jury the court shall accept the master's findings of fact unless clearly erroneous.' * * * Although advisory in the sense that it needs confirmation, the master's findings of fact are presumptively correct and should be adopted by the court unless shown to be clearly erroneous. In this case the special master has had an opportunity to hear and see the witnesses. His findings will be reversed only when this court is satisfied that error has been committed."

The report of the Special Master refers specifically to the page numbers of the testimony from which the facts are taken, and it is urged that every finding is supported by the testimony (R. 322-363).

The Circuit Court adopted the view, however, that the District Court was not bound by the findings of the Master, even though such findings were supported by the testimony; that the District Court might properly make its own findings; and that the Circuit Court was bound under FRCP No. 52 (a) to accept the findings of the District Court (R. 426-428). Petitioners urge that the rule thus laid down by

the Circuit Court is error; that the true rule is that the District Court may not set aside the findings of the Master unless the findings are wholly unsupported by the evidence, or capricious or arbitrary; and that since it is not contended that the Master's findings are unsupported by the evidence, or capricious or arbitrary, the District Court erred in substituting its own findings for the findings of the trier of the facts who saw and heard the witnesses.

V.

The District Court erred in imputing the alleged wrongful acts and knowledge of Mifflin's salesmen to Mifflin.

The Special Master, in concluding that the acts and knowledge of Mifflin's salesmen were, under the circumstances, not imputable to Mifflin, stated the applicable law as follows (R. 355):

> "There is of course a fundamental rule of law that where knowledge is acquired by an agent in the course of his agency and relates to matters concerning the business, which the agent was authorized to conduct on behalf of the principal, such knowledge acquired by the agent is imputable to the principal. But if the agent was perpetrating a fraud on the principal, acting for his own benefit and not for the benefit of his principal, the rule would not apply."

The reason for the rule is that it is presumed that the agent will inform his principal; the reason for the exception to the rule is that the presumption does not apply where the agent's relation to the subject matter, or his previous conduct, renders it certain that he will not inform his principal: *Thomson-Houston Electric Co.* v. *Capital Electric Co.*, 65 F. 341 (C. C. A. 3d, 1931); *Hart* v. *Bier*, 74 F. 592 (D. C. E. D. La. 1896); *Bank of Overton* v. *Thompson*, 118 F. 798 (C. C. A. 8th, 1902); *Dixie Guano*

Co. v. *Wessel*, 296 F. 433 (C. C. A. 4th, 1924); *American Surety* v. *Pauley*, 170 U. S. 133, 18 S. Ct. 552 (1898); *Schutz* v. *Jordan*, 141 U. S. 213, 11 S. Ct. 906 (1891); *Benedict* v. *Arnoux*, 154 N. Y. 715, 49 N. E. 326 (1898).

Judge Bard, in reaching the contrary conclusion that the acts and knowledge of Mifflin's salesmen were imputable to Mifflin, cites with approval the Master's statement of the applicable law (R. 397). Hence, both the Master and the District Court used the same rule of law to reach opposite conclusions.

The true reason for the dissimilar conclusions may be found in the differences between the premises, that is, the stated facts, upon which the respective conclusions are predicated.

The Special Master based his conclusion on the following facts:

(a) Mifflin had no knowledge or means of knowledge of the illegitimate transactions (R. 359).

(b) Mifflin's salesmen were paid by the bootleggers for their participation in the illegitimate transactions (R. 355, 356).

(c) The dealings between Mifflin's salesmen and the bootleggers were carefully concealed from the debtor because it was feared that if knowledge of the transactions came to the debtor, the salesmen would be discharged and Mifflin would cease selling rubbing alcohol compound to customers who resold to bootleggers (R. 359).

(d) The illegitimate activities of Mifflin's salesmen were in violation of orders received from debtor that rubbing alcohol compound was to be sold only for legitimate purposes, were not within the scope of their duties, and were for the benefit exclusively of Mifflin's salesmen and to the damage of Mifflin (R. 359).

(e) Mifflin investigated the requirements of its customers and did not at any time sell in excess of such amount (R. 358).

(f) Mifflin made no sales of rubbing alcohol compound to its customers in bad faith or in excess of their reasonable requirements (R. 359).

Judge Bard, however, imputed knowledge to Mifflin because, *first*, he erroneously ignored or reversed the Master's findings; and, *secondly*, overlooking the patent fact that the case arose on a demurrer to the Collector's evidence sustained by the Master, he concluded that Mifflin admitted knowledge of the illegal acts of its agents and its consequent bad faith by expressly failing to deny such knowledge (R. 390, 394, 397, 398, 399, 400, 407).

Since the Circuit Court's conclusion that Mifflin is responsible for the acts and knowledge of its employees under the general doctrine of *respondeat superior* rests on these two unsound bases and the facts found by the District Court, the conclusion itself is necessarily unsound.

It is submitted that *Zito* v. *U. S.*, 64 F. (2d) 772 (C. C. A. 7th, 1933), the case cited by the Circuit Court in support of its conclusion that even in a criminal case knowledge is imputable to the principal, does not support that conclusion for that case was decided against the defendant because the court and jury found that the defendant knew or should have known of the illegal activities sought to be imputed and therefore had actual knowledge.

Finally, none of the cases cited and relied on in the opinions of the District Court and Circuit Court, unlike the instant case, discloses a factual pattern wherein the claimant's own testimony conclusively demonstrated that its witnesses, together with the agents, were engaged in an independent, fraudulent enterprise, the success of which would be impaired or defeated by the disclosure to the prin-

cipal of the knowledge sought to be imputed. Petitioners submit it is well settled that under such circumstances the knowledge is not imputable. Recent cases reiterating that doctrine are *Great American Indemnity Co. v. First National Bank,* 100 F. (2d) 763 (C. C. A. 10th, 1938); *FDIC v. Pendleton,* 29 F. Supp. 779 (D. C. W. D. Ky., 1939); *Hooker v. New Amsterdam Casualty Co.,* 33 F. Supp. 672 (D. C. W. D. Ky., 1940).

VI.

The District Court erred in making a specific finding of the amount of alcohol alleged to have been sold by Mifflin in excess of its customers' reasonable requirements.

Finding of fact No. 3 of the Supplemental Report of the Special Master reads as follows (R. 358):

> "3. Some of the rubbing alcohol sold by the debtor corporation to its customers was later diverted by the said customers or persons herein called 'bootleggers' to whom the alcohol compound was resold by the said customers for illegal purposes. There is no proof as to the amount of the rubbing alcohol so diverted and therefore no finding as to the amount can be made."

Judge Bard, although he made a finding as to amount, admitted that the record lacks competent evidence of the exact amount of the rubbing alcohol compound alleged to have been diverted. Judge Bard said (R. 393):

> "The specific quantity of Mifflin's rubbing alcohol purchased by Glanzburg and Gold is not shown on the record before the Master. This was due, contends Government counsel, to the Master's ruling refusing to allow customers to testify to whom they sold Mifflin's product, and also to the ruling that Glanzburg could not give his best judgment of the quantity of Mifflin's product purchased through the Three Star Chemical Company. Certain rulings of the Master, as mentioned in Exception No. 8 (R. 38, 44, 79, 258-62,

272-3) precluded the admission of the testimony of customers as to the exact quantity of rubbing alcohol they purchased from Mifflin on behalf of or for the purpose of reselling to the representatives of the bootleggers. Counsel for the government contends these customers had records from which they could testify as to the exact quantity purchased and sold, whereas the representatives of the bootleggers, Glanzburg, Gold and Waldman, on whose behalf the purchases were made, did not keep such records, and when they testified they had to rely solely on their memory as to quantity purchased. I think this was error on the part of the Master. I think this testimony would have clearly revealed the amount of alcohol in excess of their reasonable requirements that flowed through these customers from Mifflin to Waldman and Glanzburg for illegal purposes."

The Alcohol Tax Unit admits that the quantity stated in the record reflects only the judgment of Waldman, Glanzberg and Goldstein and that such judgment is not the best evidence of the exact quantities. In a memorandum dated October 27, 1938, filed by the Alcohol Tax Unit with the Special Master, it was said on pages 5 and 6:

"It was evident from the testimony of Waldman, Glanzburg, and Gold that they kept no permanent record of their transactions. From the very nature of their business, it is obvious that such would be the case. The Mifflin Company, however, did keep records of the individuals and concerns in whose names their product was billed, and, these individuals being in business, kept records of their transactions in Mifflin's product. After showing from Mifflin's records the quantity of rubbing alcohol compound sold to their customers, it was the intention of the government to call these customers and ask them to testify from their records the exact amount of such product that they sold to Waldman, Glanzburg, and Gold. Under the circumstances, there is no question but that this

was the best evidence available as to the exact quantities of rubbing alcohol compound involved in this litigation, as Waldman, Glanzburg and Gold could only testify to their best judgment as to quantities, based upon either their recollections of the transactions themselves, or temporary records kept of those transactions."

A reading of the testimony of Glanzberg, Goldstein and Waldman with respect to quantities shows that such testimony lacks particularity, definiteness and certainty. For example, Glanzberg stated that he indiscriminately bought Mifflin, Addy and Bentley rubbing alcohol compound (R. 91, 93). When Glanzberg was asked how much rubbing alcohol he handled during September and October of 1935, he estimated that during these two months he handled approximately 1000 gross per month (R. 90). He was then asked to give the percentage of the said 2000 gross which was manufactured by debtor (R. 93). The witness replied that he did not keep any records; that he purchased the rubbing alcohol compound from different druggists (R. 94), and when the Special Master said to him, "Can you state what if any of that alcohol came from the Mifflin Chemical Company of your own knowledge?", the witness answered that it would not be fair for him to say the percentage, but that the greater proportion came from Mifflin (R. 94). Later on the witness said that he didn't know of his own knowledge and wasn't sure that the alcohol was manufactured by Mifflin, but that he had been told that the name C. M. Brown on the boxes indicated that it was a Mifflin product (R. 95, 96). The witness admitted, however, that he knew that at that time a lot of people were manufacturing false labels and assuming the name of Mifflin (R. 96).

Moreover, Judge Bard's findings as to amount are predicated on the theory that appellants do not deny the testi-

mony of Glanzberg, Goldstein and Waldman (R. 390, 394, 397, 398, 399, 400, 404, 405, 407). For example, Judge Bard, in finding that Mifflin sold 2720 gross pint bottles in excess of reasonable requirements in the New York area, said (R. 394):

> "The figure of 2720 gross is corroborated evidence of Waldman's testimony showing that at least that amount, approximating the amount to which he testified, passed through their hands. Since *no one has contradicted* Waldman as to the purposes for which he purchased this alcohol by pre-arrangement with Mifflin's agent Taback, I find that at least 2720 gross pint bottles were furnished these concerns in the New York area in excess of their reasonable requirements."

Obviously it was error to accept Waldman's guesses as competent evidence on the theory they are not denied, when in fact, as hereinbefore argued, petitioners have not yet had an opportunity to present their denial.

Irrespective of whether the District Court determined that the Special Master erroneously excluded the testimony of customers, *it is incontrovertible that in the present state of the record there is no competent testimony showing precisely how much rubbing alcohol was sold in excess of the reasonable requirements of Mifflin's customers.* It is suggested that the District Court may, under such circumstances, have remanded the cause to the Special Master with instructions to hear and include the testimony of the customers, but it is submitted that it was reversible error to make a finding as to amounts without evidence of the same definiteness and particularity that would be required in the proof of any other claim in bankruptcy or any other kind of legal action.

Since it is well established that the burden to offer evidence of that character is on the claimant (*Kimberly* v. *Arms*, 129 U. S. 512, 9 S. Ct. 355 (1888); *Matter of Rubins*,

74 F. (2d) 432 (C. C. A. 7th, 1935) cert. den. 295 U. S. 758, 55 S. Ct. 915 (1935); *Clements* v. *Coplin*, 72 F. (2d) 796 (C. C. A. 9th, 1934), the Special Master's finding that "no finding as to amount can be made" may not be disturbed by any reviewing court, particularly since the Alcohol Tax Unit has admitted, and the District Court has found, that the best and only competent evidence of the exact amount of the alcohol diverted is not presently in the record.

All of which is respectfully submitted.

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Dated January 19, 1942.

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In the Supreme Court of the United States

OCTOBER TERM, 1941

No. 900

JOHN E. SHERIDAN AND LEO A. CROSSEN, TRUSTEES, MIFFLIN CHEMICAL CORPORATION, DEBTOR IN BANKRUPTCY REORGANIZATION PROCEEDINGS, SECTION 77B, PETITIONER

v.

WALTER J. ROTHENSIES, COLLECTOR OF INTERNAL REVENUE, FIRST COLLECTION DISTRICT OF PENNSYLVANIA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the District Court (R. 380–409) is reported in 34 F. Supp. 164. Its opinion on motion for rehearing (R. 421–422) is not reported. The opinion of the Circuit Court of Appeals (R. 425–433) is reported in 123 F. (2d) 311.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on October 29, 1941 (R. 433). The

petition for a writ of certiorari was filed on January 24, 1942. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether sales of rubbing alcohol compound by a permittee in excess of its customers' reasonable requirements are subject to tax under Section 4 of the Liquor Law Repeal and Enforcement Act of 1935 and Article 146 of Treasury Regulations 3 as amended by Treasury Decision 4541.

2. Whether the Act and the Regulations construed to impose the tax are valid.

3. Whether in a reorganization proceeding under Section 77–B of the Bankruptcy Act the District Court erred in allowing a claim for taxes without remanding the proceeding to the special master for the taking of additional evidence, where the master had disallowed the claim but had afforded the parties full opportunity to put in their proof.

4. Whether the District Court erred in setting aside findings of fact made by the master.

5. Whether the knowledge of the debtor's sales agents as to the wrongful sales arranged by them was imputable to the debtor, and if not whether the debtor was in any event taxable.

6. Whether the finding of the District Court as to the amount of alcohol wrongfully sold by the debtor is supported by evidence.

STATUTES AND REGULATIONS INVOLVED

The applicable statutes and regulations are set out in the Appendix, *infra,* pp. 14–16.

STATEMENT

The Mifflin Chemical Corporation, referred to as the debtor, was for many years engaged in the business of manufacturing a rubbing alcohol compound under permits to withdraw and use specially denatured alcohol (R. 277–288). On the ground, *inter alia,* that it had sold quantities of its product to certain customers in excess of their reasonable requirements, its permit for 1936 was revoked and its application for a permit for 1937 was denied. *Morgenthau* v. *Mifflin Chemical Corp.,* 93 F. (2d) 82 (C. C. A. 3).

A tax of $254,746.80 was assessed against the debtor at the rate of $2 per gallon on 127,373.40 gallons of alcohol sold during the period August 27, 1935, to December 30, 1935 (R. 276). Thereafter, on January 14, 1938, the debtor filed a petition for reorganization under Section 77–B of the Bankruptcy Act (R. 1). The petition was approved on January 15, 1938, and the matter was referred generally to a special master to make findings of fact and conclusions of law and report thereon to the court (R. 3).

The Collector of Internal Revenue filed proof of claim for the unpaid tax (R. 4–5). Objections to the claim were filed by the debtor (R. 5–7, 323–324). The Collector introduced evidence in support of

the claim (R. 7–269). At the conclusion of this evidence, the debtor moved to dismiss the claim and the Collector moved for the allowance of the claim (R. 271). The master stated that neither motion was necessary since counsel for the debtor had said that he would not offer any testimony and since the case accordingly was to be decided on the evidence then in the record (R. 271). Counsel for the debtor thereupon stated that he had no intention for the present of offering any testimony, but that he would move to strike certain of the testimony introduced to support the claim, and that following the master's action on that motion would advise the master whether or not he would offer any evidence (R. 272). The motion to strike was filed on September 8, 1938 (R. 274, 317–321) and denied by the master on March 27, 1939 (R. 274–275, 321–322). In ruling on the motion the master, after adverting to counsel's reservation of the right to offer testimony, stated that he had concluded that the claim should be disallowed but that he had not finished writing his draft report and that if prior to the filing of his final report counsel should give notice of a desire to introduce evidence he would fix a date for hearing (*id.*). On April 13, 1939, counsel for the debtor notified the master that "we do not intend to produce any testimony" (R. 424).

Thereafter, on April 27, 1939, the master signed and served upon the parties a draft report recom-

mending disallowance of the claim (R. 322–357). The master found that the debtor through two of its salesmen made sales for illegal purposes and that these were not within the reasonable requirements of the purchasers. He concluded, however, that the knowledge of the agents as to the illegal diversion by the customers was not imputable to the debtor and that this circumstance was decisive against the claim for the tax. (R. 352–357.) A supplemental report adopting as final the draft report, supplemented by certain findings of fact requested by the debtor, was prepared by the master (R. 360–363), but he died before signing it. A substituted special master was appointed by the District Court, and on July 11, 1939, he filed a supplemental report approving and incorporating the reports of his predecessor (R. 364–365).

On July 24, 1940, after hearing upon exceptions filed on behalf of the Collector, the District Court rendered its opinion setting aside the report and directing that the tax claim be allowed in the amount of $187,488, together with interest at one-half percent per month from January 15, 1938 (R. 380–409). The debtor filed a motion for rehearing praying that the District Court either disallow the claim or remand the proceeding to the master for the taking of further testimony (R. 409–420). The motion was denied in an opinion (R. 421–422), and on February 10, 1941, the District Court entered its

order setting aside the master's report and allowing the claim in the amount above stated (R. 422).

On April 4, 1941, after the debtor had filed notice of appeal, the District Court entered a decree appointing John E. Sheridan and Leo A. Crossen, petitioners herein, trustees of the debtor corporation (R. 423). Their appointment was confirmed (R. 2) and they prosecuted the appeal to the court below, which affirmed the order of the District Court (R. 433).

ARGUMENT

The decision of the court below affirming that of the District Court is correct and no conflict or other reason for further review is presented. We will answer petitioners' numerous contentions in the order in which they are made.

1. Petitioners contend (Pet. 14–19) that even if the debtor sold its product to customers in excess of their reasonable requirements, as found by the District Court (R. 395–396), such sales were not taxable. This contention was overruled by both lower courts (R. 383, 408, 430). It is based on an untenable construction of the wording and purpose of Section 4 of the Liquor Law Repeal and Enforcement Act of 1935 (49 Stat. 873) and of Article 146 of Treasury Regulations 3, as amended by Treasury Decision 4541, XIV–1 Cum. Bull. 525, 528 (1935).

Section 4 of the Act provides that any person selling denatured alcohol "in violation of laws or regulations now or hereafter in force pertaining

thereto" should be subject to all provisions of law applicable to alcohol not denatured "including those requiring the payment of tax thereon" and should be required to pay the tax, which in this case under Section 2 (4) of the Liquor Taxing Act of 1934 (48 Stat. 313) amounted to $2 per proof gallon (Appendix, *infra*, p. 14). Article 146 of the regulations provides that sales must be confined to certain classes of purchasers and that failure to confine sales to such persons "or the making of sales to such persons in quantities in excess of their reasonable requirements, will constitute bad faith on the part of the permittee and grounds for the revocation of his permit (Appendix, *infra*, p. 15)."

Petitioners argue that this provision, although authorizing revocation of permits on account of sales in excess of reasonable requirements, does not prohibit such sales and that therefore petitioners were guilty of no violation and were not taxable. However, such sales would hardly have been made ground for revocation if it had not been intended to forbid them. The plain purpose of the regulatory and statutory provisions is to protect the revenue by insuring that tax-free alcohol is not diverted and that, if diverted, it will be taxed. It would not effectuate this purpose to read the provisions in the narrow manner urged by petitioners. The provisions are remedial, not penal.[1]

[1] *Various Items* v. *United States*, 282 U. S. 577, 579. Cf. *Helvering* v. *Mitchell*, 303 U. S. 391, 399–405.

And there is nothing in the history of Article 146 to support the claim that because of the difficulty of determining what constitutes "reasonable requirements" in a given instance, sales in excess thereof were not intended to be made taxable. The same difficulty would exist in a proceeding to revoke the seller's permit.

2. Petitioners contend (Pet. 20) that Section 4 of the Liquor Law Repeal and Enforcement Act as applied by the courts below constitutes an unconstitutional delegation of legislative power to the Commissioner, and that Article 146 of the regulations, as applied, is unauthorized. These propositions are unsupported by any authority and are without merit. Section 4 of the Act does not purport to authorize the Commissioner to prescribe a tax. On the contrary the tax was fixed by Congress in Section 2 (4) of the Liquor Taxing Act of 1934 (Appendix, *infra*, p. 14). And Article 146 is clearly valid under the provisions of Section 13 of Title III of the National Prohibition Act (Appendix, *infra*, p. 16) authorizing the Commissioner to issue such regulations governing the distribution, sale, and use of alcohol as may be necessary or proper to secure the revenue and to prevent diversion of alcohol to illegal uses.

3. It is contended (Pet. 21–25) that the District Court erred in allowing the claim without remanding the proceeding to the master in order to afford

petitioners an opportunity to introduce any evidence which they might have to defeat the claim. But, as appears from the statement of facts (*supra*, p. 4), the debtor had ample opportunity to offer evidence in the proceedings before the special master. It simply chose not to do so. The master made it clear that his action disallowing the claim would not be taken upon the debtor's motion for disallowance, but would be a final disposition upon all the evidence which the parties desired to introduce (R. 271, 274–275). Hence the case may not be likened to one in which a dismissal of the suit at the close of the plaintiff's evidence makes it unnecessary for the defendant to put in its testimony. The debtor here could not assume that the disallowance would be sustained and then, after the claim was allowed, delay the proceedings by securing a remand for the purpose of adducing evidence which the master clearly indicated should have been offered, if at all, prior to his report. It may be noted, moreover, that in its motion for rehearing the debtor did not allege what evidence it desired to adduce (R. 419–420), and that in denying the motion the judge was satisfied that no purpose would be served and no pertinent facts would be established by a remand (R. 422).

The decisions relied on by petitioners (Pet. 10, 22–23) were based upon circumstances dissimilar

to those herein and they do not conflict with the decision of the court below.[2]

4. Petitioners contend (Pet. 25–27) that the District Court erred in setting aside the findings of fact made by the master. No particular findings are specified, nor is the sufficiency of the evidence discussed. Moreover, as was pointed out by the District Court (R. 396), the findings of fact made by it were not at variance with those of the master, except in the case of several which dealt with the debtor's knowledge of the diversions of its product and which, insofar as not based on erroneous principles of law, were found to have been unsupported by any evidence (R. 397–407, 408–409). The District Court explicitly stated (R. 397) that the master's findings should be sustained if supported by substantial evidence, and, contrary to petition-

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[2] The referee's disallowance of the claim in *In re John H. Livingston Co.*, 144 Fed. 971 (C. C. A. 2d), was taken upon a motion for disallowance, and, so far as appears from the *per curiam* opinion, there was no occasion for the trustee to introduce any evidence if he desired to do so. The proceeding in *In re Crandall*, 205 Fed. 689 (C. C. A. 9th), was remanded for the reason that the district court erred in treating as conclusive evidence which was not conclusive and which the referee had ignored. The referee in *In re Arthur E. Pratt Co.*, 252 Fed. 917 (N. D. N. Y.), had erred in restricting the introduction of evidence, and in *In re Tenenbaum & Abramowitz*, 56 F. (2d) 217 (S. D. N. Y.), the proceeding was remanded because the referee had failed to consider a presumption in favor of the claimant and the district court had no way of knowing what his findings would have been if the presumption had been taken into account.

ers' assertion (Pet. 26), the same view appears to have been held by the court below (see R. 426, note 4). Thus there is no conflict with the decisions cited by petitioner (Pet. 11, 25) for the same rule.[3]

5. It is contended next (Pet. 27–30) that the courts below erred in overruling the master's conclusion that the debtor was not chargeable with its agents' knowledge of the sales for illegal purposes, which concededly were sales in excess of its customer's reasonable requirements within the meaning of Article 146. The master and perhaps also the District Court considered that scienter was a necessary element of the debtor's taxability (R. 354–357, 396–409). The court below did not decide this question but stated that for purposes of argument it would assume that the debtor was liable for the tax only if knowledge of the diversions was attributable to it (R. 430).

Neither Article 146 nor the pertinent statutes contain any provision that a taxpayer must have knowledge that its sales are wrongful. Certainly it would not be unreasonable to place upon him as a condition of tax exemption the duty of seeing that his sales are proper. Such a duty would seem especially appropriate in circumstances like

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[3] *Kimberly* v. *Arms*, 129 U. S. 512; *In re Pullmatch, Inc.*, 27 F. Supp. 884 (S. D. Ohio); *Wald* v. *Longacre*, 34 F. (2d) 25 (C. C. A. 3d); *Clements* v. *Coppin*, 72 F. (2d) 796 (C. C. A. 9th); *In re Rubins*, 74 F. (2d) 432 (C. C. A. 7th), certiorari denied, 295 U. S. 758.

those here, where the debtor's sales sharply increased during the period in question (R. 388–389, 398). See *Morgenthau* v. *Mifflin Chemical Corp.*, 93 F. (2d) 82, 86, 88 (C. C. A. 3). In any event, the imputation of knowledge here was correct.[4] The two salesmen involved admittedly knew of the illegal diversions and, while in arranging the sales they may have been acting primarily in their own interest, they were not acting beyond the scope of their authority or adversely to their principal.

6. Finally, petitioners contend (Pet. 30–34) that the evidence did not warrant the District Court in making any finding as to the specific amount of alcohol wrongfully sold by the debtor. The District Court found (R. 395) that the debtor's wrongful sales amounted to at least 3,720 gross pint bottles. The evidence supporting this finding is carefully detailed in the court's opinion and the record references are given (R. 384–396). Where the judge found that the proof was not clear, he did not credit it; the original assessment was reduced from $254,746.80 to $187,488. The court below held

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[4] See *Zito* v. *United States*, 64 F. (2d) 772 (C. C. A. 7), and other cases cited in the opinion of the District Court (R. 400–406). See also Restatement of Agency, Secs. 228–231, 282.

The decisions invoked by petitioners (Pet. 11, 27–28) as presenting conflicts with the holding herein were correctly distinguished by the court below (R. 432) on the ground that the agents there involved acted adversely to their principals in the sense either of defrauding them or of acting for the other parties to the transactions.

that there was a substantial basis for the finding as to the amount of the sales, and there is no occasion for further review.

CONCLUSION

The petition for writ of certiorari should be denied for the reasons stated.

Respectfully submitted.

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APPENDIX

Liquor Taxing Act of 1934, c. 1, 48 Stat. 313:

> SEC. 2. Paragraphs (3) and (4) of subdivision (a) of section 600 of the Revenue Act of 1918, as amended (relating to the tax on distilled spirits generally and the tax on distilled spirits diverted for beverage purposes) * * *, are amended to read as follows:
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> "(4) On and after the effective date of Title I of the Liquor Taxing Act of 1934, $2.00 on each proof gallon or wine gallon when below proof and a proportionate tax at a like rate on all fractional parts of such proof or wine gallon."

Liquor Law Repeal and Enforcement Act, c. 740, 49 Stat. 872:

> SEC. 4. Any person who shall produce, withdraw, sell, transport, or use denatured alcohol, denatured rum, or articles in violation of laws or regulations now or hereafter in force pertaining thereto, and all such denatured alcohol, denatured rum, or articles shall be subject to all provisions of law pertaining to alcohol that is not denatured, including those requiring the payment of tax thereon; and the person so producing, withdrawing, selling, transporting, or using the denatured alcohol, denatured rum, or articles shall be required to pay such tax. (U. S. C., Title 26, Sec. 3111.)

Treasury Regulations 3, as amended by T. D. 4541, XIV–1 Cum. Bull. 525, 528 (1935):

> ARTICLE 146. * * * The sales of this product must be confined to persons legitimately engaged in a bona fide drug trade, or to hospitals, sanitariums, turkish baths or other establishments or stores where such compounds have customarily been sold, or used for massage or other external purposes. Failure to comply with these requirements and to confine sales to such persons, or the making of sales to such persons in quantities in excess of their reasonable requirement will constitute bad faith on the part of the permittee and grounds for the revocation of his permit.

National Prohibition Act, c. 85, 41 Stat. 305, Title III:

> SEC. 5. Any tax imposed by law upon alcohol shall attach to such alcohol as soon as it is in existence as such, and all proprietors of industrial alcohol plants and bonded warehouses shall be jointly and severally liable for any and all taxes on any and all alcohol produced thereat or stored therein. Such taxes shall be a first lien on such alcohol and the premises and plant in which such alcohol is produced or stored, together with all improvements and appurtenances thereunto belonging or in anywise appertaining.
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> SEC. 10. Upon the filing of application and bond and issuance of permit denaturing plants may be established upon the premises of any industrial alcohol plant, or elsewhere, and shall be used exclusively for the denaturation of alcohol by the admixture of such

denaturing materials as shall render the alcohol, or any compound in which it is authorized to be used, unfit for use as an intoxicating beverage.

Alcohol lawfully denatured may, under regulations, be sold free of tax either for domestic use or for export.

SEC. 11. Alcohol produced at any industrial alcohol plant or stored in any bonded warehouse may, under regulations, be withdrawn tax free as provided by existing law from such plant or warehouse for transfer to any denaturing plant for denaturation, or may, under regulations, before or after denaturation, be removed from any such plant or warehouse for any lawful tax-free purpose.

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SEC. 13. The commissioner shall from time to time issue regulations respecting the establishment, bonding, and operation of industrial alcohol plants, denaturing plants, and bonded warehouses authorized herein, and the distribution, sale, export, and use of alcohol which may be necessary, advisable, or proper, to secure the revenue, to prevent diversion of the alcohol to illegal uses, and to place the nonbeverage alcohol industry and other industries using such alcohol as a chemical raw material or for other lawful purpose upon the highest possible plane of scientific and commercial efficiency consistent with the interests of the Government, and which shall insure an ample supply of such alcohol and promote its use in scientific research and the development of fuels, dyes, and other lawful products.

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